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America's Community Bankers®

November 9, 2000

Manager, Dissemination Branch
Information Management & Services Division
Office of Thrift Supervision
1700 G Street, N.W.
Attention: Docket No. 2000-57
Washington, D.C. 20552

Re: Proposed Rule on Mutual Savings Associations, Mutual Holding Company Reorganizations, and Conversions From Mutual to Stock Form, 65 FR 43092 (July 12, 2000)

Dear Sir or Madam:

America's Community Bankers ("ACB") is pleased to comment on the Proposed Rule issued by the Office of Thrift Supervision ("OTS") governing mutual institutions, mutual holding company reorganizations, and mutual to stock conversions.[1] ACB represents the nation's community banks of all charter types and sizes. ACB members pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.

Proposed Rule

Through this proposal, the OTS seeks to implement a comprehensive regulatory strategy governing mutual institutions, mutual holding company reorganizations and mutual-to-stock conversions. Specifically, the OTS is developing new analytical techniques, examination procedures, and industry guidance to address, within the context of safe and sound operations, many of the concerns mutual institutions have raised about their business form and to improve supervision of mutual institutions. The proposed regulations govern conversions from mutual to stock form, including pre-conversion and application requirements, voluntary supervisory conversions, and mutual holding company formations in connection with mutual-to-stock conversions.

[1] 65 Fed. Reg. 43092 (July 12, 2000).

Background

By way of background, mutual savings institutions were founded by individuals, for themselves and their neighbors, who lacked the financial wherewithal required to gain access to the existing banking system at the time. The doors of commerce that banking opened for the well-to-do were closed to average citizens. Mutual institutions stepped into this breach to provide high quality consumer banking services to their depositors and their communities, and they continue this tradition today. Because of their intimate involvement with their communities during and after banking hours, they have become an important part of the local culture and community.

ACB's membership includes the majority of savings institutions currently in mutual form, including both savings associations chartered and regulated by the OTS and state-chartered savings banks whose primary federal regulator is the FDIC. While we strongly support the efforts of the OTS to revise and update the agency's regulations and supervisory policies applicable to mutual institutions and mutual holding companies, ACB has a policy of also supporting a rational conversion process. Whether an institution remains in mutual form is a matter for its board of directors, management, and ultimately its members. We do not believe that the OTS or any other regulatory agency should be in the position of making that kind of judgment unless there is a safety and soundness concern.

Distributions of Capital

Before discussing the specifics of the proposal, ACB would like to highlight one of the questions posed by the OTS as being particularly troublesome.[2] The OTS asks whether it should develop regulations or guidance regarding special capital distributions by mutual institutions. ACB is strongly opposed to the issuance of any regulation or guidance on this type of distribution. Many institutions have the power to make such distributions, if management believes that such distributions would be in the best interests of the institution, and the agency also has ample supervisory authority to review such distributions when made by a mutual institution based on its capital position and other relevant factors. Mutual institutions develop these types of plans based on their community and financial conditions. We believe that the issuance of a regulation or guidance in this area might cause depositors, members of the community, or others to misapprehend that they have a right to receive such distributions and would create expectations about them. These issues have been settled by the courts and by agency action, however, there continue to be instances in which parties disrupt the operation of a mutual institution or second guess management decisions by demanding that distributions be made. We strongly urge the OTS to eliminate this issue as one under consideration as part of this rulemaking.

General

ACB supports the OTS's efforts both to improve the regulatory scheme for mutual institutions and mutual holding companies, and to enhance the viability of the mutual form of organization.

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[2] Id. at 43094.

ACB strongly believes that all depository institutions should retain the freedom to choose the form of organization that best meets their strategic and market objectives. Toward that end, ACB encourages the OTS to develop final regulations that will produce the necessary improvements in the regulatory process while preserving an institution's flexibility to choose the corporate form best suited to its business.

ACB strongly urges that the proposed business plan requirements be substantially revised. We support the development of supervisory changes that will reflect the operations of mutual institutions. We also strongly support the issuance of guidance that will clarify that compensation policies designed to attract and retain qualified employees will be within the purview of management, and that OTS examiners will review these plans only for safety and soundness reasons, relying principally on review of these plans by management. Further, ACB supports a number of the changes proposed in the mutual holding company area, including the benefit plan revisions and eliminating the requirement that a vote be taken in a transaction in which a mutual holding company is formed and no minority shares are issued. We support the willingness of the OTS to consider options that will increase the flexibility of the mutual holding company and we have several suggestions.

Finally, we encourage the OTS to develop supervisory methods and tools that recognize the unique characteristics of mutual institutions. The use of peer group information is important and should be encouraged with accurate information. We also welcome such changes as the revision of the pre-examination response kit. Our more specific recommendations are discussed in detail below.

Mutual-to-Stock Pre-application Process

Under the proposed regulations, mutual institutions that are planning to convert to stock form would be required to meet with their regional OTS office and submit a business plan for prior approval before proceeding to file a full conversion application.[3] This pre-application process would be expected to last at least 30 days. ACB believes that the proposed pre-application process would unnecessarily lengthen a conversion timeline that already averages several months in duration. While there is obvious value in pre-filing meetings, ACB believes that many of the objectives contemplated by this provision can be incorporated effectively into the conversion application process without adding further delays.

For example, while the Comptroller of the Currency ("OCC") encourages converting institutions to have pre-filing meetings with OCC staff in an effort to identify unusual or complex issues, there is no separate business plan approval process.[4] Rather, the business plan is a key element of the application. Similarly, the OTS should encourage converting mutual savings associations to meet with OTS regional staff. However, the dialogue that occurs during the pre-filing meeting should facilitate but not be included within the formal application process. ACB opposes a

[3] Id. at 43104.
[4] 12 CFR Part 5.

separate business plan approval process during the pre-filing meeting stage. The business plan review should be a key component of the OTS conversion application process. We believe this process still would identify issues that must be addressed more adequately, which would, in turn, produce an improved conversion application. Requiring prior regional approval of business plans after pre-filing meetings, however, would significantly extend conversion timetables without producing additional benefits to the application process.

ACB encourages the OTS to use its existing authority when reviewing conversion applications to deny those proposals that lack comprehensive business plans which meet safety and soundness standards. Furthermore, the OTS should ensure that meaningful discussions occur during a pre-filing meeting between potential applicants and regional officers. The regional OTS office should serve as a resource for an applicant institution that is considering filing a conversion application. Once an institution has made a deliberate and strategic decision to convert, however, we believe the regulatory application process should be as thorough, comprehensive and *efficient* as possible.

Supporting the Continued Viability of the Mutual Form

The OTS also has requested comment on how the agency can make it more attractive for mutual institutions to stay in mutual form.[5] ACB fully supports all efforts toward this goal. For example, we are in favor of the OTS allowing mutual institution affiliations; such potential arrangements represent a good opportunity for mutual institutions to enjoy certain economies of scale while still preserving their respective independence and community focus. We do not believe, however, that such efforts should be at the expense of other, equally viable forms of organization. Moreover, when considering capital raising strategies, mutual holding companies should not always be preferred over full mutual-to-stock conversions. Again, ACB strongly favors providing financial institutions with the widest menu of structural options.

Business Plan Requirements

Under the proposal, the OTS has outlined several key elements of a conversion business plan that it deems to be essential.[6] With respect to this information, ACB believes there should be several revisions.

Under the proposal, business plans submitted by applicant associations would be expected to include a discussion of the institution's record of success and experience in implementing prior growth or expansion initiatives. Moreover, the OTS would "encourage institutions with management that does not have sufficient or favorable experience with expansion to consider alternatives to conversion."

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[5] 65 Fed. Reg. 43097.
[6] Id. at 43104.

Although a converting institution in most instances should be able to demonstrate satisfactorily to the OTS that it possesses the requisite management experience, qualifications and other resources to effectively lead an expansion, many successful, well-run mutual institutions operate in slow or even no-growth markets. In such cases, the lack of experience in managing an institution through a period of expansion would not necessarily suggest that management is not prepared to lead a successful conversion. We believe the standard proposed by the OTS is unduly subjective and allows the agency to decide arbitrarily what is "sufficient" or "favorable" management experience, circumventing what essentially is an appropriate business decision. At best, the standard is protectionist; at worst, it replaces an institution's obvious right to choose its future with agency edicts. In its final rule, the OTS should clarify that prior growth management experience will be a factor that is considered when reviewing both business plans and full conversion applications, but that the absence of such management experience will not be determinative.

The proposed regulations also would require that institutions converting from mutual to stock form be prepared to deliver, as detailed in business plan projections, a minimum return on equity that exceeds, by a margin reflecting relative investment risk, the institution's rates on long-term certificates of deposit. In addition, the OTS has indicated that converting mutual institutions may not include such factors as stock repurchases or other capital returns in *pro forma* business plans.[7]

ACB believes that establishing such narrowly defined business plan parameters would significantly impede the ability of converting institutions to develop reasonable and well-designed mutual-to-stock conversion plans. The proposed performance standard of the long-term certificate of deposit rate plus a risk factor is likely to greatly exceed the historical performance of most converting mutual institutions, and any converted mutual institution would be unlikely to attain this arbitrarily established standard in the shorter term, much less exceed that performance. The reasons for this are simple: (1) the converted institution must initiate new business plans from the old earnings base; (2) the injection of new capital must necessarily drive down ROE and other performance measures while capital is being deployed; and (3) new investments generally require some period to become fully productive. Therefore, any financial plan that adds significant amounts of new capital, whether in a mutual-to-stock conversion, or any other similar IPO or capital restructuring for other types of companies, will result in the shorter term in lower performance measures as compared against historical trends for the business. It is only after a business plan has been executed fully, and after investments have been made and bear fruit, that performance can return to or exceed historical levels. Furthermore, as the OTS has noted, a variety of circumstances will combine to vary the timeframe necessary for any individual institution to achieve a full return on investment; such timeframes likely may be beyond the three-year period contemplated in the proposal.

The performance standard proposed by OTS would have the unintended result of rendering the rest of the proposed rule moot. If the performance standard in the business plan is generally

[7] Id.

unattainable, no mutual-to stock-conversions will occur. Also, such an unattainable performance standard will effectively prevent most second-stage conversions of mutual holding companies, or worst, precipitate declines in mutual holding company stock values to levels necessary to generate threshold performance measures to permit otherwise desirable second-stage conversions.

During this comment period, ACB met with financial analysts and other experts who support our conclusions. Despite ACB's fundamental misgivings about the practicable application of the proposed business plan projection and return on equity proposal, we agree with the OTS that a business plan justification for conversion is appropriate and necessary. Taking into account that an institution must start with its historical earnings potential, and that an injection of capital must necessarily reduce return on equity in the shorter term, ACB strongly recommends that performance be benchmarked from historical experience. The business plan also should provide for an orderly deployment of capital designed to return performance to the historical experience level or higher within a reasonable timeframe. Moreover, although business plans that project higher than historical performance might appear to be the most desirable, a sound business plan that does not include meaningful changes in financial performance may be well-founded because of the likelihood of producing a stable, diversified company offering a greater range of services.

Finally, when developing conversion business plans, we believe it is important for savings associations to retain the flexibility to incorporate every available financial tool into their financial planning. The proposed narrow focus on return on equity, while an important feature of any *pro forma* business plan, ignores other performance measures that may be equally important, such as the projected return on investment, a standard that today finds greater acceptance among analysts. Any single ratio should not, in and of itself, form the bright line test for an acceptable business plan. Rather, business plans should be evaluated by a range of performance measures where possible.

Mutual Holding Company Revisions

The OTS asks how the agency can revise its regulations on mutual holding companies to make the corporate form more attractive to those savings associations considering conversion.[8] The agency also wants to remove any impediments to mutual holding companies that do not wish to do a second step conversions. The changes made to the mutual holding company regulations in the interim final rule issued concurrently with this proposal will go a long way to making the mutual holding company a more attractive corporate form.[9] Specifically, the modification of the dividend waiver requirement and the implementation of the additional powers granted in the Gramm-Leach-Bliley Act provide mutual holding companies the tools to remain long- term alternative to conversion.

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[8] Id. at 43096.
[9] 65 Fed. Reg. 43088 (July 12, 2000).

As noted above, the proposed business plan requirements may inhibit an institution from forming a mutual holding company or may make a second step conversion a less appealing option. When a mutual institution forms a mutual holding company and does not issue stock, the change is transparent to almost everyone. The added flexibility provided by the holding company is only apparent when the savings association enters a new line of business or establishes an affiliate of the association. If the holding company does issue stock, it still represents only a minority of the shares.

We believe that the process by which a mutual holding company is formed should be as streamlined as possible. For example, ACB does not believe a depositor vote should be required when no stock is being issued. The rights of the members are not be being affected by the transaction. Further, we request that the business plan requirement for mutual holding companies be more flexible than those for a full conversion. This is especially true if no stock is being issued.

It appears that if a mutual holding company does a second step conversion, the OTS conversion requirements would be applied, we recommend that a more streamlined application process be developed for second step transactions. In the situation in which a mutual holding company has issued minority shares, management has had to operate in many respects like a public company.

Another of the questions asked by the OTS is what currency may mutual holding companies use to accomplish transactions. The agency asks whether acquisitions can be made using trust preferred securities, REITs, and stock repurchases to issue stock for acquisitions.[10] ACB requests that the OTS develop a final regulation that is as flexible as possible. The alternatives listed in the preamble to the proposal are not available to every mutual institution. In fact, in most cases, the transactional costs of issuing trust preferred securities or establishing a REIT can not be justified by mutual or mutual holding companies. The repurchase of shares or the use of shares that have previously been repurchased is an option that the OTS should permit for a mutual holding company wishing to make acquisitions.

In the past few months the OTS has approved transactions that indicate a willingness to consider alternatives. We recommend that the OTS amend the mutual holding company regulations to specifically authorize the mid-tier subsidiaries or savings association subsidiaries of mutual holding companies to be able to offer their shares in exchange for shares of stock depository institutions. The mutual holding company would retain 51 percent of the stock. This could be done without an offering being made to existing stockholders, but the agency could require a fairness opinion indicating that the transaction is in the best interests of the depositors of the savings association subsidiary.

Another recommendation that would specifically enhance the formation of multi-tiered mutual holding companies would be to permit the mid-tier to be organized under state law. When the OTS authorized the creation of the multi-tiered mutual holding companies, the agency required

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[10] 65 Fed. Reg. 43097.

that the mid-tier be a federal entity. To the extent that the mid-tier is organized under state law, the company and its directors would have the protections and the benefits of a well-developed body of statutory and case law.

An important proposed change to the regulations would give mutual holding companies additional flexibility to issue options under stock benefit plans. The savings association subsidiary or the mid-tier may offer management benefit plans or stock option plans as if minority shareholders hold 49 percent of the stock, provided the mutual holding company retains majority control. For example, a stock option plan could be adopted that includes 4.9 percent of the outstanding shares even if an amount less than 49 percent of the shares were issued. We believe that this proposed change will help mutual holding companies to develop management compensation plans. We also support the ability of a savings association or mid-tier to adopt these benefit plans at the time of the reorganization.

The proposed requirement that purchasers of stock must approve the plan by a separate vote on the stock order form and the six-month delay in the ability of the savings association or the mid-tier to make grants are reasonable. ACB also supports the ability to adopt additional option plans without requiring that stock be issued to all categories of subscribers, so long as certain conditions are met. These changes would be important to mutual holding company managers in developing compensation packages that will allow them to attract and retain qualified employees.

Compensation

Another issue the OTS is reviewing in the context of this comprehensive reform of regulation and supervisory policy in connection with mutual institutions and mutual holding companies is compensation. A concern of many boards and managers of mutual institutions is the ability to attract and retain qualified employees. Because a mutual institution cannot offer stock option plans or other benefit programs available to stock institutions, they must develop more creative ways to compensate employees and directors. The changes referred to in the previous section are important to the ability of mutual holding companies to offer competitive compensation. Another example is the use of phantom stock benefit plans. We encourage the OTS to work with mutual institutions to develop these plans. Further, we support the proposed amendments to the management stock benefit plans contained in the proposed conversion regulations.

ACB strongly supports the issuance of supervisory guidance on compensation practices of mutual associations. In addition to the concern that qualified individuals will not be able to be retained, management at mutual institutions also has expressed a concern about the supervisory treatment of compensation programs. Currently, Regulatory Bulletin 27a provides general guidance about what examiners will look at in terms of compensation. We believe that it is very important for the OTS to ensure that its examiners and regional offices look at compensation as a matter for management and the board to determine absent safety and soundness concerns. ACB recommends that Regulatory Bulletin 27a be amended to clarify the role of examiners in reviewing compensation especially for mutual institutions.

In addition to not being able to offer stock-based plans, mutual institutions do not have the market oversight of compensation that comes from being a public company. In using their subjective judgment, examiners sometimes take on the role of market review. Guidance issued by the OTS should confirm that board oversight can be used and that compensation is a management decision unless there is a safety and soundness concern. The regional offices should be prepared to discuss novel compensation plans with mutual boards while the plans are under development so that management can be assured that they will not be criticized later, unless the financial condition of the institution changes.

Revision of Policy Regarding Acquisitions

The current and proposed regulation contains a prohibition on any person or company acquiring more than 10 percent of any class of equity security of a converted institution for three years post conversion without OTS approval. If a person or group acquires more than 10 percent of a class of equity securities during the three-year period, they may not vote the shares in excess of the 10 percent.[11] The purpose of this regulation is to allow savings associations a reasonable time to deploy the proceeds of the conversion and to become acclimated to being a public company. ACB believes that such a time period may be three to five years. Frequently, persons or companies will acquire shares as part of a conversion and will quickly move to force management to sell the institution so that these shareholders can benefit from the transaction. In the preamble to the proposal, the OTS confirms that the position of the agency remains that acquisitions institutions within the first three years post conversion are not always in the bests interests of the institution. In fact, the agency states that it will take a very close look at applications submitted by persons or entities to make acquisitions within the three-year period.[12]

ACB strongly supports the enforcement of this provision. There are situations, including for safety and soundness purposes, when such an acquisition is in the best interests of the association, and we believe that that OTS review process will be able to determine those instances. However, if the converted association is following the business plan that it developed and had approved as part of the conversion process, and is operating in a safe and sound manner, prospective acquirers should be required to meet a very high standard to be granted an exception to the prohibition.

Other Revisions to the Regulation

Charitable Organizations. One of the changes made in the proposal would be to clarify that the creation of a charitable foundation is permitted and to specify the requirements.[13] ACB supports this change. The creation of charitable foundations has become a method by which a converted association or mutual holding company can meet unique community needs. The inclusion of specific provisions in the regulation on formation as well as post conversion activities is very

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[11] Id. at 43112.
[12] Id. at 43096.
[13] Id. at 43114.

helpful. ACB recommends that an additional clarification be made. There is confusion about whether and to what extent foundation activities or investments in these foundations by the institutions can be granted credit for CRA purposes. We request that guidance be issued on this point.

Demand Account Holders. ACB supports the change that clarifies that demand account may be included in "qualifying deposit " and may be included in determining who will receive subscription rights.

Creation of Bankers' Banks

The OTS asks about the level of interest among mutual institutions for the creation of bankers' banks that focus on the needs of community based mutual institutions.[14] To the extent that OTS has the authority to charter such organization, ACB supports this idea. As mentioned above, the ability of mutual institutions to join together and realize efficiencies and economies of scale is very important. The creation of bankers' banks that could help in this process could be a constructive way to accomplish the goal.

Conclusion

ACB appreciates the opportunity to comment on this important matter and supports the OTS in its efforts to provide an enhanced regulatory scheme for mutual organizations, including institutions that elect to convert to the stock form or organization. ACB represents the majority of the nation's mutually chartered institutions and strongly supports all efforts to foster the ongoing viability of the mutual form of organization because we believe that financial institutions must have the flexibility to select the charter form that is best suited to their markets and strategic goals. We stand ready to work with the OTS in developing a final rule that meets this objective.

If you have any questions, please contact the undersigned at (202) 857-3121 or cbahin@acbankers.org, or Michael W. Briggs at (202) 857-3122 or mbriggs@acbankers.org.

Sincerely,

Charlotte M. Bahin

Charlotte M. Bahin
Director of Regulatory Affairs and
Senior Regulatory Counsel

[14] Id. at 43096.